

**DIRECT TESTIMONY OF
B.R. SKELTON, Ph.D.
CAROLINA WATER SERVICE, INC.
DOCKET NO. 2006-92-W/S**

1 **Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.**

2 A. My name is B. R. Skelton and my business address is 2962 Walhalla Highway,
3 Six Mile, South Carolina 29682. I am Professor *Emeritus* of Economics at Clemson
4 University and am engaged in a variety of private business endeavors, including real
5 estate brokerage and residential construction. I also act as a mediator and arbitrator.
6 Since 1974, I have mediated 190+ disputes and written decisions in over 1000 arbitration
7 cases, mostly union-management grievances. I have also arbitrated deferrals from the
8 courts and the NLRB.

9 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND**
10 **PROFESSIONAL EXPERIENCE.**

11 A. I received my B.S. degree in Arts & Sciences (History & Economics) from
12 Clemson University in 1956. In 1958, I received a Masters of Science degree in
13 Agricultural Economics from Clemson University. I received my Ph.D. in Economics
14 from Duke University in 1964.

15 From 1959 to 1987, I was a professor of Economics at Clemson except for 1961-
16 63 when I was in graduate school at Duke University. In addition to teaching standard
17 economic theory, my academic background includes writing, lecturing and research in
18 the areas of labor economics, economic development and arbitration. While at Clemson,
19 I was a member of the Southern Economics Association and American Economic
20 Association. I was also a member of the Arbitration Panel of the Federal Mediation and

1 Conciliation Service and the American Arbitration Association. I retired from Clemson
2 in 1987.

3 **Q. PLEASE DESCRIBE YOUR WORK IN THE REAL ESTATE FIELD.**

4 A. Over time I have developed subdivisions, commercial property, apartments and
5 bought and sold real estate of all types.

6 **Q. DO YOU PROVIDE ANY CONSULTING SERVICES?**

7 A. I have served as a consultant to various individuals and companies, mostly
8 wrongful death and injury, divorce, product liability and valuation of business losses. I
9 was President of Economic Research and Consulting Associates prior to 1980, the
10 business that provided this analysis. I have testified before the PSC in one case involving
11 a water company in Oconee County.

12 **Q. DO YOU HOLD ANY OTHER PROFESSIONAL DESIGNATIONS?**

13 A. Yes. I am a mediator and arbitrator and am licensed by the State of South
14 Carolina as both a real estate broker and residential contractor. I am also an elected
15 member of the National Academy of Arbitrators and have been a member since 1981.

16 **Q. DR. SKELTON, PLEASE DISCUSS THE BASIS FOR YOUR OPINIONS IN THIS**
17 **CASE.**

18 A. I am qualified to offer my opinions in this case based on my studies, research,
19 teaching, writing and consulting in the field of economics and on my experience as a real
20 estate investor and broker and as a business person.

21 My opinions are based on my analyses of the relevant materials I have reviewed
22 to date, opinions of current and former academic colleagues in the field of economics,
23 and my fifty years of teaching, writing, researching, consulting, and lecturing in the field

1 of economics. I may supplement, refine, or revise my analyses as appropriate based on
2 additional testimony, documents, or other materials that may become available in this
3 case.

4 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

5 A. The purpose of my testimony is to express opinions regarding the impact that
6 general economic conditions during the course of the last twelve months should
7 reasonably be expected to have on the allowable return on equity granted by this
8 Commission to Carolina Water Service, Inc., or “CWS,” in its last rate case. In addition,
9 I will opine as to the range of returns on equity supported by the testimony of CWS
10 witness Pauline Ahern.

11 **Q. WHAT KEY DOCUMENTS AND OTHER MATERIALS DID YOU CONSIDER**
12 **IN REACHING YOUR OPINIONS?**

13 A. The key materials used by me in my analysis are as follows:

- 14 • Commission Order Number 2005-328 in Docket Number 2004-357-W/S.
- 15 • 10 year bond yields, federal funds rate, prime rate, C.D. rate, Libor rate,
16 trends in economic activity and employment data.
- 17 • Prepared Direct Testimony of Pauline M. Ahern, Vice President of AUS
18 Consultants – Utility Services, filed on behalf of CWS.

19 **Q. DR. SKELTON, WHY HAVE YOU REVIEWED THE COMMISSION ORDER IN**
20 **THE COMPANY’S LAST RATE CASE?**

21 A. I reviewed the Company’s most recent rate case order so that I could to determine
22 what range of returns on equity the Commission considered and the specific return it
23 selected.

1 **Q. WHAT DID YOUR REVIEW OF THAT ORDER REVEAL IN THAT REGARD?**

2 A. In the Company's last rate case, the Commission set a return on equity of 9.10%
3 from a range it adopted of 9.10% of 10.10%. I would note that it is my understanding
4 that the Company has sought judicial review of the Commission's determination in that
5 regard.

6 **Q. DOES THE RETURN ON EQUITY SET IN THE COMPANY'S LAST RATE**
7 **CASE BEAR ON YOUR OPINION IN THIS CASE?**

8 A. Yes, but the number is only incidental to my opinion.

9 **Q. WOULD YOU ELABORATE ON THAT LAST STATEMENT?**

10 A. Yes. Regardless of whether one agrees with the return on equity set in the
11 Company's last rate case, it does establish a benchmark that is relevant to this case. This
12 is so because, if one assumes that the return on equity of 9.10% set just twelve months
13 ago was reasonable, then one can apply basic economic theory to approximate what a
14 reasonably corresponding return on equity would be today using that benchmark. Of
15 course, depending upon the generally prevailing economic circumstances during the
16 twelve month interim period, that approximation of a reasonably corresponding return on
17 equity today could be higher or lower than the benchmark return that is used.

18 **Q. WHAT IS THE BASIC ECONOMIC THEORY TO WHICH YOU ARE**
19 **REFERRING?**

20 A. During the past twelve months the Federal funds rate, bond yields, prime rate and
21 C.D. rate have all increased. No prudent and reasonable investor would be willing to
22 invest today unless they could expect to earn a higher return than when the above rates
23 were lower, as they were a year ago. Moreover, as rates on competing investments

1 increase, bond rates and interest costs are likely to increase for companies competing for
2 additional funds.

3 **Q. DR. SKELTON, WOULD YOU PLEASE DESCRIBE THE GENERAL**
4 **ECONOMIC CONDITIONS WHICH HAVE PREVAILED IN THE UNITED**
5 **STATES OVER THE LAST TWELVE MONTHS?**

6 A. Yes. In general, the country has experienced the potential and actual inflationary
7 pressures, reflected in the increases in the Federal Funds Rate and corresponding interest
8 rates. The stock market has shown profitability and stock price increases making that
9 market more competitive for the funds of investors.

10 **Q. DR. SKELTON, IN LIGHT OF THE GENERAL ECONOMIC CONDITIONS**
11 **FOR THE PAST TWELVE MONTHS THAT YOU HAVE JUST DESCRIBED,**
12 **WOULD A REASONABLE RETURN ON EQUITY BE HIGHER OR LOWER**
13 **THAN THAT SET IN THE COMPANY'S LAST RATE CASE?**

14 A. In my opinion, it would have to be higher when basic economic principles are
15 applied. The answers to the two previous questions provide the rationale for this opinion.

16 **Q DR. SKELTON, ARE YOU FAMILIAR WITH THE BASIC STANDARDS THAT**
17 **APPLY IN SETTING THE ALLOWED RATES OF RETURN FOR PUBLIC**
18 **UTILITIES?**

19 A. Yes, I have a general understanding that the *Bluefield*¹ and *Hope*² decisions of the
20 United States Supreme Court have established that a utility should be allowed an
21 opportunity to realize earnings at a sufficient level so that it is able to attract capital at

¹ *Bluefield v. Public Service Commission, et.al.*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176, 1923 U.S. LEXIS 2676 (1923).

² *Federal Power Commission, et. al. v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333,

1 reasonable cost and an opportunity to realize earnings at a level comparable to firms
2 facing equivalent risk.

3 **Q. DO YOU ALSO HAVE A GENERAL UNDERSTANDING OF PRINCIPLES OF**
4 **ECONOMICS WHICH ARE IMPORTANT TO AN ESTIMATE OF THE COST**
5 **OF EQUITY CAPITAL FOR A UTILITY?**

6 A. Yes, I do and it would be the same as for any business. In the economics of
7 finance, I understand that two principles that are generally accepted when estimating the
8 cost of capital for a firm are (1) that a firm should not undertake new investments in plant
9 and equipment unless the prospective return on such investments equals or exceeds its
10 cost of acquiring capital funds and (2) that risk and return are interrelated such that
11 investors in a firm with higher than average risk must be compensated by the promise of
12 a higher than average return.

13 **Q. IN YOUR REVIEW OF MRS. AHERN'S TESTIMONY, DO YOU FIND THAT**
14 **SHE APPLIES THESE STANDARDS AND PRINCIPLES?**

15 A. Yes, I do. Of course, her analysis is extensive and addresses many other issues
16 which bear on her opinion, but I read her opinion as recognizing the standards and
17 principles I just discussed.

18 **Q. DO YOU AGREE WITH MRS. AHERN'S OPINION REGARDING AN**
19 **ESTIMATE OF A REASONABLE RANGE OF RETURNS ON EQUITY FOR**
20 **THE COMPANY?**

21 A. Yes, I do agree with Mrs. Ahern's recommended range of 11.10% to 11.75%. I
22 would note that she arrives at this determination as a matter of informed judgment based
23 upon an extensive analysis which involves the application of several different models to

1 approximate reasonable returns on equity. As her testimony reflects, these models
2 individually produce estimated returns of as much as 14.10% and as little as 9.90%.
3 Given rising interest rates, as evidenced by the 0.76% increase in the average yield on
4 Moody's "A" rated public utility bonds from May, 2005, to April, 2006, as shown on
5 page 4 of Exhibit PMA-10 accompanying Mrs. Ahern's testimony, a range of 11.10% to
6 11.75% seems eminently reasonable.

7 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

8 A. Yes, it does.